SMALL REFINER RIK PROGRAM UNDERPAYMENTS

Background

The Minerals Management Service (MMS) is reviewing the amounts billed under the small refiner oil royalty in kind (RIK) program. Under the program, small refiners purchase the royalty oil MMS takes in kind for use in their refineries. The legislative purpose of the program is to provide small refiners with access to adequate supplies of oil for refining. MMS has billed small refiners based on information reported by the producers. Because many producers reported value based on posted prices, MMS initially billed on that basis. MMS believes these prices do not represent market value and has begun billing small refiners for an additional increment of the purchase price.

An MMS team was formed to develop a method to properly value oil sold to small refiners. It attempted to obtain arm=s-length contracts for the sale of oil produced from the same leases or fields to adjust the previous bills. However, some producers refused to provide MMS with the requested contracts, perhaps because they thought that if their contracts disclosed they were selling at posted prices plus a premium, they would be billed for additional royalties on oil for which royalties were paid in value. For months the MMS team pursued the contracts unsuccessfully. Finally, the team estimated the value of oil sold to some small refiners based on the spot prices in or near the production areas.

Company Status

MMS has billed one onshore refiner (Wyoming Refining) for oil it purchased from Federal leases in North Dakota and Montana. In addition, our Colorado audit partners obtained arms length contracts for a large producing field and MMS recently billed additional value for a few months in 1997. Wyoming Refining then terminated its contract to purchase RIK oil. The other companies purchasing onshore oil (Gary-Williams, Big West Oil and Sinclair) also terminated their contracts, some due to the billing actions and others for operational reasons. These companies had been purchasing RIK oil produced in the states of Wyoming, Montana, Utah, North Dakota and Colorado since mid-1987.

Several companies purchasing offshore RIK also terminated their contracts. AGE Refining and Gold Line Refining dropped their contracts due to pricing uncertainties. Canal Refining and LL&E Refining sold their refineries and terminated their contracts. It is not clear whether pricing uncertainties were involved in their decisions. Those companies still purchasing offshore production include Gary-Williams Refining (2 contracts); Calcasieu Refining; Giant Industries; Placid Refining; and US Oil and Refining. Most of these contracts have been in force since mid-1994 and MMS is renegotiating the contracts to assure that future deliveries would be billed at fair market value. Values will be based on spot/index prices and most will be effective from August 1998 forward.

Estimated Underpayments

The following table shows the volumes and the potential underpayments for RIK production sold to small refiners. The amounts are estimates and most need verification prior to being billed. In total, 96 million barrels of oil were sold to small refiners between 1987 and 1997 (about 60 percent of the volumes were from offshore leases). The approximate total underpayment is between $105 million and $122 million. Because MMS was unsuccessful in obtaining arm=s-length contracts, the estimates are based on spot prices. Except for Gary-Williams and Wyoming Refining, which were billed for some production, small refiners are not yet aware of the potential dollar magnitude involved.

	Barrels Sold	Potential Underpayment
Offshore Current Contracts	42.3 million	$52-62 million
Offshore Terminated Contracts	15.3 million	19-22 million
Onshore Terminated Contracts	38.3 million	34-38 million

The estimated underpayments were not included as part of the audit receipt estimates in the FY 1999 budget, and therefore we don=t believe that legislation containing some form of forgiveness language would affect scoring. The audit receipt dollars in the budget are based on historical averages and not on expected collections from specific issues such as this one. We would include this money in the receipts at the point we expect to make the collections.

Options for Resolution

All of these options are administratively feasible but some may require legislation. Any option that decreases revenues may be opposed by States that share in those revenues.

Bill Total Underpayment--Those refiners willing to pay market value for future RIK production are working with MMS to establish the framework for those future prices. However, if they are billed the full amounts for past volumes, it could adversely affect negotiations and in fact they may drop out of the program entirely. In addition, several refiners have argued that bills for the full underpayment amounts could force them into bankruptcy. Bankruptcies would likely mean that MMS would collect little or nothing for the bast underbilled volumes. Also, it would negatively impact the economies of the States where the refineries are located through the loss of jobs, tax revenues, etc. If this occurs, all involved parties lose. Such a result is also not in keeping with the underlying purpose of the legislation.

Bill Total Underpayment and Provide a Special Payment Plan--Similar to above. However, for those companies still purchasing current production offshore, this may be a more positive resolution. If a company were to use a deferred payment plan, an increment for past undervaluation and associated deferred payment interest could be added to and spread over the bills for production for the remainder of the current contract. For those companies that have terminated their contracts, a deferred payment plan could facilitate collection in some cases. However, for those that are not in stable financial condition, collections even under a deferred plan could meet with limited success. This option would not require legislation.

Forgive Total Underpayment--Would please all current and past refiners. Some of the States which receive a share of the amounts received by MMS for RIK oil sold to refiners for oil produced from certain Federal leases in or offshore their boundary would likely object to forgiveness because they would not receive any additional funds. Forgiveness should not be extended to refiners with a history of late, erroneous or non-payment nor to refiners who have sold the RIK oil rather than refining it as required by the small refiner program. Legislation would be required.

Forgive Interest Payments--No impact. Based on longstanding policy, small refiners are not assessed any interest on billings for past underbilling for oil unless they fail to remit the billed amount within 30 days of the date of the bill. In this case, interest would begin to accrue at the end of the 30 day period. This non-billing of interest is based on MMS Director=s appeal decisions.

Step/Sliding Scale Payments-- Bills could be discounted by a certain percentage for production taken during different time frames. (For example, a company could pay 90% of the amount owed for production taken from 1997 forward, 75 % of the amount owed for production taken in 1996, 60% for production taken in 1995, and so forth.)

Another alternative would be to discount the differential between postings and spot prices. This may provide more certainty in the amounts to be billed and simplicity in calculating those amounts. This alternative could also be coupled with the reduction scale discussed above.

Legislation would be required for both alternatives.

Negotiated Settlements--MMS has been working on this alternative with little success. States are very involved in MMS=s settlement process and probably would not agree to substantial discounts on underpayments. However, MMS has succeeded in establishing a framework for current production value on continuing contracts. Also, negotiations could be used in combination with some form of step scale billing approach.